Daniel H. Mudd

Vice Chairman and
Chief Operating Officer

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
202 752 8400
202 752 1304 (fax)
daniel_h_mudd@fanniemae.com

January 14, 2005

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
U.S. House of Representatives

The Honorable Sue W. Kelly
Chairwoman
Subcommittee on Oversight and Investigations
U.S. House of Representatives

The Honorable Robert W. Ney
Chairman
Subcommittee on Housing and Community Opportunity
U.S. House of Representatives

Dear Chairman Baker, Chairwoman Kelly and Chairman Ney:

I am pleased to respond to your December 1, 2004 letter regarding First Beneficial Mortgage Company. Fannie Mae appreciates each of your leadership, on our regulatory oversight headed by Chairman Baker and Chairwoman Kelly, and on the serious issue of mortgage fraud led by Chairman Ney. Your letter raises many important questions regarding First Beneficial in particular and mortgage fraud in general.

Fannie Mae has engaged outside legal counsel to investigate the facts surrounding how our personnel handled the First Beneficial matter. This inquiry has not yet concluded. In order to respond to Congress in a timely fashion, we have provided responses to your questions that reflect the facts as we understand them today. We respectfully request your permission to amend or supplement our responses should we learn anything new.

Since we received your letter, the U.S. District Court for North Carolina issued a Consent Order, dated December 8, 2004, reflecting the agreement between Fannie Mae and the Department of Justice under which Fannie Mae has provided $7,500,516.08 to the government. This amount includes $6,522,188.08 that the government identified as coming from First Beneficial's fraud, plus an additional $978,328 in stipulated interest. Fannie Mae did not wish to retain the funds or benefit from First Beneficial's illegal activities. As noted in the Consent Order, Fannie Mae itself was a victim of the mortgage fraud scheme perpetrated by First Beneficial's principals, James and Macy McLean. The U.S. Attorney's Office in North Carolina began its prosecution of the McLeans and their associates in May 2001. Fannie Mae substantially assisted the government in its

successful prosecution and conviction of the defendants in the proceeding, including through extensive testimony of several Fannie Mae employees. The Consent Order also acknowledges that in these post-conviction ancillary forfeiture proceedings, Fannie Mae acted quickly to review the matter and fully cooperated with the government in reaching final resolution. The U.S. Attorney's Office has told us it considers this matter resolved.

Let me begin with a short summary of the issue as the circumstances surrounding First Beneficial provide an example of only one type of mortgage fraud. The problem of fraud in the mortgage industry is serious and research indicates that the incidence of mortgage fraud has increased in the last several years. The FBI has announced that it currently has 533 pending mortgage fraud investigations compared with 102 in 2001. As required by money laundering laws, banks filed over 12,000 Suspicious Activity Reports (SARs) in the first nine months of 2004 as compared to just over 4,000 reports in all of 2001.

This increase in mortgage fraud has had immense implications for the mortgage industry as a whole. As noted by the Mortgage Bankers Association (MBA) at Representative Ney's Subcommittee's hearing on October 7, 2004, lenders, taxpayers, homebuyers and neighborhoods suffer as a result of mortgage fraud schemes. Shortages in funding for mortgage fraud prosecution and gaps in inter-agency and inter-lender communication about fraudulent activity exacerbate the problem. As discussed more fully below, Fannie Mae supports the recommendations of the FBI and the MBA made at the October 2004 hearing with respect to mandatory reporting of mortgage fraud, including a safe harbor for reporters of suspected fraud, and increased government and industry communication regarding mortgage fraud.

As the case of First Beneficial highlights for us, there is more that Fannie Mae can do to improve its practices to prevent losses from mortgage fraud to the company, its partners and the taxpayers. While Fannie Mae is not aware of other instances where an entity of the Federal government was sold fraudulent loans held originally by Fannie Mae,[1] we have publicly stated our intent to work with Congress, HUD and others to establish an appropriate process for sharing information. We have also established an internal, cross-functional task force to review our policies and approaches, and recommend continued improvements.

As with the rest of the industry, Fannie Mae's practices are evolving to meet the demands of the changing mortgage fraud landscape. In the years since the fraud perpetrated by First Beneficial, Fannie Mae has taken steps to consolidate its loan review processes and

[1] Subsequent to your letter, Fannie Mae conducted due diligence with respect to employees within the company in the best position to be aware of any such instance. For purposes of consistency in definition, Fannie Mae's inquiry defined a "sale" as the purchase for cash or mortgage backed securities by Ginnie Mae or any other entity of the Federal government of a fraudulent loan from a third party who directly or indirectly acquired the loan from Fannie Mae, including by means of a repurchase of the loan from Fannie Mae. During its history, Fannie Mae has purchased millions of dollars of loans insured or guaranteed by government agencies, and Fannie Mae and/or its servicers have submitted insurance or guaranty claims under such loan programs and in some cases assigned such loans or properties secured by such loans to the governmental agencies. We did not review these loans in connection with this inquiry, as we do not consider assignments in connection with insurance claims to be "sales."

develop stronger internal policies with respect to fraud. In addition, as indicated in our testimony submitted for the October 2004 hearing and as discussed below, Fannie Mae has devoted substantial resources to actively prevent the most common kinds of mortgage fraud. One of our highest priorities is to provide lenders with technology that will help them detect fraud at the point of sale. This will mitigate losses to lenders due to fraud and allow lenders to gain access to multiple fraud mitigation tools.

At the time First Beneficial was approved as a Fannie Mae Seller/Servicer in 1995, the company followed a decentralized approval process for lenders. Approval of new Seller/Servicers was managed by the lead regional office assigned to that lender by geographic location. In 1995, Fannie Mae's Southeastern Regional Office, located in Atlanta, covered North Carolina and thus was the office that received First Beneficial's application to become a Fannie Mae approved Seller/Servicer. In 1995, Sam Smith, in his capacity as the Vice President for Single Family Operations in the Southeastern Region, was responsible for overseeing the new lender approval process.

Before a lender may do business with us, it must meet all of the requirements of our Selling and Servicing Guides. The requirements are designed to ensure that the institutions that sell loans to Fannie Mae have the structure, resources and expertise to originate and service mortgages. Fannie Mae periodically updates its Guides to reflect evolving practices in the mortgage market. Today, as in 1995, the Guides contain uniform requirements for Seller/Servicers throughout the country. In 1995, Fannie Mae followed the approval criteria in effect at that time in approving First Beneficial.

These criteria were that the lender:

- Have as one of its principal business purposes the origination and servicing of residential mortgages;
- Demonstrate a proven ability to originate and service the type of mortgage(s) for which our approval is being requested, and employ a staff with adequate experience in that area;
- Be properly licensed, or otherwise authorized, to originate and sell residential mortgages in each of the jurisdictions in which it does business;
- Have an acceptable net worth of $250,000. A lender requesting approval for additional categories of loans must have additional net worth in a dollar amount that represents 2/10% of the outstanding principal balance of any Fannie Mae portfolio it is already servicing. The lender must also be otherwise financially acceptable to us;
- Maintain quality control and management systems to evaluate and monitor the overall quality of its loan production and servicing activities; and
- Have in effect a fidelity bond and errors and omission coverage and agree to modify them as necessary to meet our requirements.

In addition to the requirements of the Guides, Fannie Mae began a Minority and Women Owned Lender ("MWOL") initiative in 1994. The goal of the initiative was to increase minority homeownership through an increase in the number of MWOLs as Fannie Mae approved Seller/Servicers. The MWOL initiative encourages cultivation of relationships

with MWOLs and, at the time, included a mentoring feature under which an MWOL could be partnered with a mentoring lender with expertise in areas needed to strengthen the MWOL's operations.

In 1995, Fannie Mae's Southeastern Regional Office declined First Beneficial's initial application to become an approved Seller/Servicer. The declination was based on a full assessment of the lender's compliance with the requirements of our Guides, which found deficiencies in underwriting, quality control and servicing expertise. Fannie Mae took steps to bring First Beneficial into such a mentoring relationship with an established Fannie Mae lender, but the mentoring arrangement became unnecessary after First Beneficial recruited experienced staff to address its areas of deficiency and provided additional documentation to Fannie Mae. First Beneficial was approved as a Fannie Mae lender in August 1995.

First Beneficial began delivering loans to Fannie Mae in December 1995. Our records indicate that First Beneficial's fraudulent activity probably began in 1997, two years after the initial approval. Most of the loans delivered by First Beneficial to Fannie Mae were not fraudulent.

The approval process, however, has evolved over the years based on our assessment of changes in the industry's risk climate. In 2002, we revised the lender approval section of our Selling Guide. The revisions primarily focused on ensuring that lenders are approved to sell us only those mortgages that we consider them to be qualified to originate. In addition, language was added to clarify Fannie Mae's discretion in approving seller/servicers based on a comprehensive view of their qualifications (e.g., that meeting individual requirements does not entitle a lender to Fannie Mae seller or servicer approval).

This revision coincided with a centralization of our small lender management for new lenders with traditional lines of business. This group was created to ensure appropriate, centralized business process and management of small-to-medium-size accounts. This reorganization recognized the unique needs of small lenders in becoming Fannie Mae customers.

In addition to a completed online application, new applicants must sign and submit a Statement of Certification verifying the accuracy of information submitted online, authorization for verifying credit and business references, and signed copies of the Mortgage Selling and Servicing Contract. For unregulated lenders, we require additional documentation that includes two years of audited financial statements, resumes for key management positions, policies and procedures for each functional area, quality control reports, and closed loan files. We review this information and conduct a background search seeking information about the applicant and its principals.

At the time irregularities in First Beneficial's loan deliveries to Fannie Mae surfaced in 1998, the quality control loan reviews for that lender were performed in the Atlanta

office. Loan deficiencies and instances of suspected fraud were handled on a case-by-case basis by the regional offices.

As a result of changes in technology and in an effort to ensure review consistency and leverage resources, the post-closing file review function is now centralized. We now employ a systematic sampling system to select both newly delivered and defaulted loan files for review every month. This includes a random statistical sample from which review results are extrapolated to allow us to analyze the loan quality of the entire loan portfolio. It also includes a large sample of early payment defaults and loans secured by recently foreclosed properties that are in our real-estate-owned inventory. Several additional units within Fannie Mae perform specialized loan reviews and feed their results via a centralized quality assurance system.

Fannie Mae has also established an investigations team that is focused on mortgage loan fraud reviews, research and reporting. This team reviews misrepresentation cases that involve patterns, and follows up on tips of potential fraudulent activity provided from within and outside the company. The emphasis of this group's work is investigating "fraud for profit" schemes rather than misrepresentations designed to help a borrower get into a house. These "fraud for profit" cases tend to be where the scope of the fraud and the losses suffered are greatest. Within "fraud for profit" schemes, the perpetrators are typically industry professionals, such as appraisers, underwriters and affiliated parties. If there appears to be a pattern of misrepresentations with a certain lender, appraiser, originator, or location, the investigations team will attempt to validate the preliminary misrepresentation findings, look for direct contradictions in loan files and attempt to evaluate motivation. In our experience, in only comparatively few cases are the principals of the lender found to be directly engaged in fraudulent activity.

Currently, when Fannie Mae discovers that a lender has sold us a loan that contains material misrepresentation(s), we generally ask the lender to repurchase the loan from us or to reimburse us for our losses if the loan has defaulted. If we find that a loan is part of a wider pattern of irregular activity, we take further action depending on the specific circumstances. These actions may include requiring the lender to demonstrate that it has taken corrective action internally, suspending or terminating the lender(s) involved, notifying law enforcement, reporting loan participants to their respective licensing authorities and/or reporting the incident(s) to a cooperative industry database.

At the October 2004 hearing, we shared many of our recent anti-fraud initiatives with the Subcommittee. We have devoted a research team to developing tools in our automated-underwriting system, Desktop Underwriter. These tools shift the quality assurance emphasis from the back-end of the loan origination process (post-closing reviews) to the front-end (pre-funding reviews). They provide notifications to the lender that are actionable at the time potential fraud is first detected – before the loan is approved, closed and sold to Fannie Mae. Examples of these tools include notifications to the lender when our internal information indicates that a Social Security Number is invalid and/or when the appraised value of the secured property appears to be inflated.

These initiatives are directed at our efforts to assist lenders in reducing the volume of mortgage fraud occurring in the primary mortgage market. We are simultaneously undertaking similar initiatives in the investigative and information-sharing areas – initiatives that we believe will assist the industry in meeting the specific challenges expressed by the MBA.

These initiatives recently culminated in the adoption of an internal corporate-wide anti-fraud policy in August 2004. This policy codified existing practices and established new requirements. Under the policy, Fannie Mae employees have explicit responsibility to prevent and detect fraud. Managers of business units are responsible for identifying and evaluating activities and operations that create risks for fraud, and for implementing fraud prevention and detection measures designed to address those risks. In cases where activity might violate the law, the policy provides that Fannie Mae "may refer such activities to the appropriate law enforcement or governmental authorities…"

In mid-1998, during a review of First Beneficial's loan deliveries, Fannie Mae found several irregularities with respect to some of the loans and First Beneficial's servicing practices. These irregularities included missing documentation and missing insurance on some loans. As a result, those loans were rendered ineligible for sale to Fannie Mae, thus triggering Fannie Mae's contractual right to require First Beneficial to repurchase the ineligible loans. (Loans that do not qualify for sale to Fannie Mae are generally not invalid loans. For example, they could be loans that Fannie Mae cannot legally hold, such as loans over an 80 percent loan-to-value ratio without credit enhancement, but that other investors may purchase).

Fannie Mae suspended First Beneficial as a qualified lender in November 1998. As a result of physical inspection of properties underlying some of the First Beneficial loans, Fannie Mae became aware that the properties were either vacant or were under construction – in which case those loans were also ineligible for sale to Fannie Mae. Loan repurchases of some, but not all, of First Beneficial's loans took place in December 1998, February 1999, December 1999, and February 2000. During this period, First Beneficial also entered into a tri-party servicing agreement to put the remaining First Beneficial portfolio under Fannie Mae's control.

While it is not Fannie Mae's practice to require lenders to disclose the source of funds for loan repurchases, Fannie Mae employees asked First Beneficial about its source of funds because of First Beneficial's capital position. James McLean told Fannie Mae representatives that First Beneficial had found several subprime loan investors that would purchase loans that did not qualify for sale to Fannie Mae. McLean would not reveal the identity of any investor, citing a fear that Fannie Mae would contact them and raise concerns that would ward off investors.

After receipt in October 2000 of a HUD letter to James McLean alleging fraud perpetrated on Ginnie Mae, Fannie Mae did not permit any loan repurchases by First Beneficial. At the time of receipt of the October 2000 HUD letter, Fannie Mae still held approximately 190 First Beneficial loans and had already suffered credit losses with

respect to First Beneficial loans. Fannie Mae cooperated with the ensuing federal inquiry and provided substantial assistance in the government's successful conviction of James and Macy McLean and their associates in 2003. The following current and former Fannie Mae employees from its Atlanta office testified at the McLean trial: Sam Smith, Vice President of Single Family Operations, Everett Biggerstaff, Special Servicing Representative (then retired); and Nitin Dave, Customer Account Manager.

Prior to receipt of the October 2004 letter, the only communications Fannie Mae received with respect to Ginnie Mae's possible involvement with First Beneficial came in November 1998. An employee of the Atlanta office received a call in November 1998 from the North Carolina State Banking Commission. The Commission's investigator stated he was investigating First Beneficial and requested Fannie Mae's assistance. The investigator stated he would send a package of information on loan files to Fannie Mae and Fannie Mae pledged to assist in whatever way possible once the materials were reviewed. The investigator also stated that First Beneficial was attempting to get Ginnie Mae to buy loans. The reference to Ginnie Mae was not specific to loans owned by Fannie Mae. Despite Fannie Mae's pledge of assistance, no Fannie Mae employee recalls any further follow up from the North Carolina investigator and the promised package was never received.

The same Fannie Mae employee spoke with two employees of First Beneficial, one of who was leaving the company, and received varying accounts of problems at the lender. In the course of a broader discussion about problems at the lender, one employee stated that First Beneficial's only two investors were Fannie Mae and Ginnie Mae. During a similarly broad conversation on a number of topics, the other employee speculated that First Beneficial might be trying to buy loans back from Fannie Mae and sell them to Ginnie Mae. The company received no further information regarding Ginnie Mae's involvement with First Beneficial until the company received HUD's October 2000 letter alleging fraud against First Beneficial.

A review of the totality of the facts in hindsight suggests that Fannie Mae may have been able to take further steps to investigate and determine whether First Beneficial was engaging in conduct that amounted to fraud. At the time, Fannie Mae did not have a formal policy in place to address potential instances of fraud. Fannie Mae also does not routinely issue a public notice when it suspends a seller/servicer whether or not the suspension is as a result of suspected fraud or some other reason. One of the primary reasons for this is that misrepresentations on the part of a lender do not per se constitute actionable civil or criminal fraud. A lender may make misrepresentations inadvertently and unknowingly, negligently, or intentionally. Like others in the industry, in most if not all instances of suspected fraudulent activity, Fannie Mae's concerns are based solely on limited information and circumstantial evidence. As the MBA recently testified before the Subcommittee on Housing and Community Opportunity, reporting just a suspicion of fraud or making unfounded allegations of fraud raise potential privacy and confidentiality concerns and can expose the reporting entity to liability for defamation, breach of contract and other claims. In addition, working cooperatively with a lender can minimize losses to the entity that is subject to the potential fraud. There are substantial incentives

for entities to handle problems with lenders internally. For these reasons, we support the industry's proposal to create a "safe harbor" for reporters of potential mortgage fraud even if the alleged conduct is later found to be negligence.

We also support the FBI's recommendation that suspected fraud reporting be made mandatory by law and to improve communications between those who can assist in uncovering fraud and those who prosecute it. As we have stated, we are committed to working with Congress, HUD and others to put in place appropriate information-sharing procedures.

In summary, Fannie Mae took what it believed at the time to be reasonable steps to resolve problems with what it perceived as a small, inexperienced and negligent lender. This approach appeared further justified by McLean's desire to work cooperatively with Fannie Mae to remedy deficiencies.

Your letter also asks about the impact of the First Beneficial matter on the housing goals. Where appropriate and in accordance with HUD's housing goals regulation, Fannie Mae counted the dwelling units financed by the loans it purchased from First Beneficial toward its housing goals in 1996-1998.

Under HUD's regulations, Fannie Mae must count the total number of dwelling units (not loans) financed by eligible mortgage purchases or MBS guarantees toward the achievement of its housing goals.[2] Most government loans are not considered eligible mortgage purchases and are thus excluded completely from the calculation that determines whether Fannie Mae achieves its housing goals. Of all the loans delivered by First Beneficial, only 86 loans were considered eligible mortgage purchases from which the dwelling units financed by those loans could be counted for housing goals. Because one of these loans indicated that it financed three dwelling units, the number of dwelling units required for inclusion in the denominator of the housing goals calculation over the three-year period totaled 88.

Of the 88 dwelling units (from the 86 eligible mortgage purchases) that Fannie Mae was required to put in the denominator of each of the three goals in either 1997 or 1998, very few units were determined to meet any of the three housing goals and thus very few units were put in the numerator for the calculation. The denominator for 1997 and 1998, for example included in excess of 1.5 million and 3.2 million loans, respectively. Consistent with HUD's regulations, Fannie Mae did not retroactively adjust its affordable housing goals calculations for 1997 and 1998 to remove the units financed by the loans repurchased by First Beneficial. If the qualifying loans repurchased by First Beneficial had been removed from Fannie Mae's housing goals scores, the scores reported to HUD for any of the three goals in 1996-1998 would have been exactly the same.

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[2] The total number of dwelling units financed by eligible mortgages is placed in the denominator of the housing goals calculation. Only those units that actually meet the affordability tests of the goals may be placed in the numerator for that specific goal. The numerator is then divided by the denominator to determine the company's achievement of that goal.

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Thank you for the opportunity to submit this information to your Subcommittees. We would be happy to brief you and your staffs on any questions you may have.

Sincerely,